LYNCHPIN
MARKET STRATEGY, LLC

Midyear Market Outlook

July 10, 2026

Executive Summary

The first half of 2026 was defined by geopolitical shocks, higher energy prices, persistent inflation, and resilient economic and market fundamentals. While we expect these fundamentals to remain firm, heightened global tensions, inflation, and rising market interest rates may narrow the path for returns in the months and quarters ahead.

Policy/Economy - In the U.S., the war in Iran pressured inflation and bond yields, but consumption, fiscal incentives tied to the OBBBA, and AI-related investment helped sustain growth. The Federal Reserve is expected to remain cautious amid above-target inflation, rising deficits, and the leadership transition to Kevin Warsh, with policy uncertainty likely to remain elevated. We look for the US GDP to grow in the range of 2.0% over the next twelve months.

Fixed Income – Bond markets were challenged by higher Treasury yields and fiscal concerns, though elevated income, narrow credit spreads, strong corporate fundamentals, and healthy municipal balance sheets continue to support demand. The yield on the 10-year Treasury will likely trade in the range of 4.25% to 4.75% for the remainder of the year, depending on progress with the war in Iran.

Equities - Equity markets endured an early drawdown before rebounding to new highs, led by strong earnings, AI investment, and broader market participation. Valuations are elevated, but profit growth remains supportive, with midterm election-year volatility a key risk. Profit growth remains strong and we'd view the S&P 500 as fairly valued in the 7,850 range by year end.

Global - The IMF lowered growth forecasts and raised inflation projections as war-related disruptions affected energy, commodity, and agricultural markets. Still, global markets have shown resilience, with Emerging Markets outperforming Developed Markets, helped by semiconductor exposure, China's export growth, and trade realignments. Geopolitical developments and currency stability will remain key for global economic and financial market performance.

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Policy & Economy

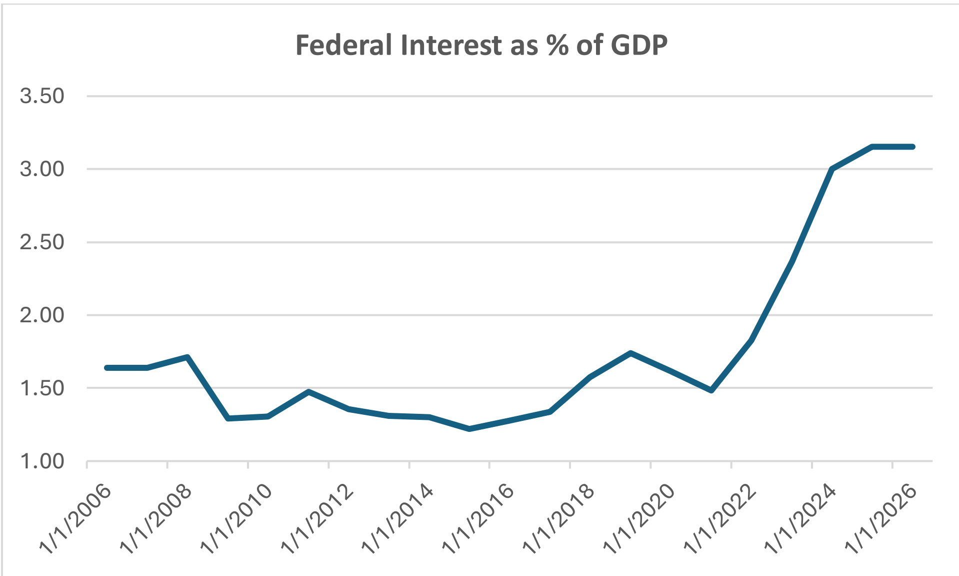
The year began in relative calm before geopolitical tensions escalated, leading to volatility in the economy and financial markets.

The war in Iran led to a surge in energy prices, pressuring inflation measures, and limiting some of the benefits of the One Big Beautiful Bill Act (OBBBA). The financial markets wavered, as bond yields climbed and the S&P 500 approached correction territory before rallying to new all-time highs as the second quarter progressed.

Fiscal policy continued to provide support.

The fiscal incentives associated with the OBBBA and a surge in AI-driven investment helped offset near-term war worries, and trade volatility moderated as the US struck trade agreements with numerous countries. However, widening federal budget deficits and surging government debt remain longer-term problems, particularly as interest costs climb.

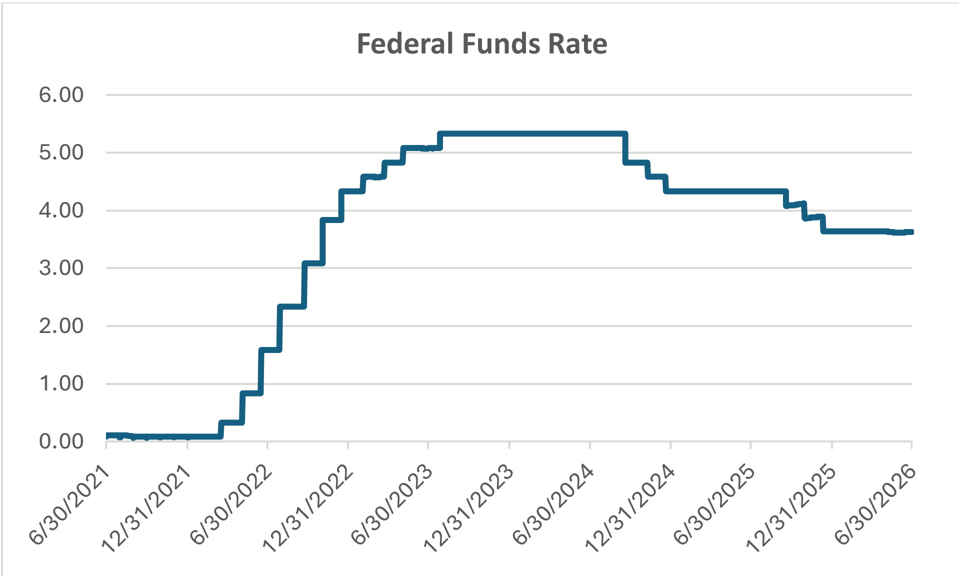
Chart – Federal Interest as % of GDP



Monetary policy remains a central focus as inflation risks moved higher.

To be sure, market interest rates have nudged higher in the first half of the year as inflationary pressures intensified and government debt climbed. While headlines may suggest otherwise, we look for the Federal Reserve to remain on hold (3.50%-3.75%) through 2026. However, if the recent war escalation persists through the summer months, then a quarter point rate hike is likely on the table in the fourth quarter. Moreover, the leadership transition — with Kevin Warsh becoming new Chair — will add another layer of uncertainty amid above-target inflation, rising global bond yields, and a more hawkish global monetary policy backdrop.

Chart – Federal Funds Rate

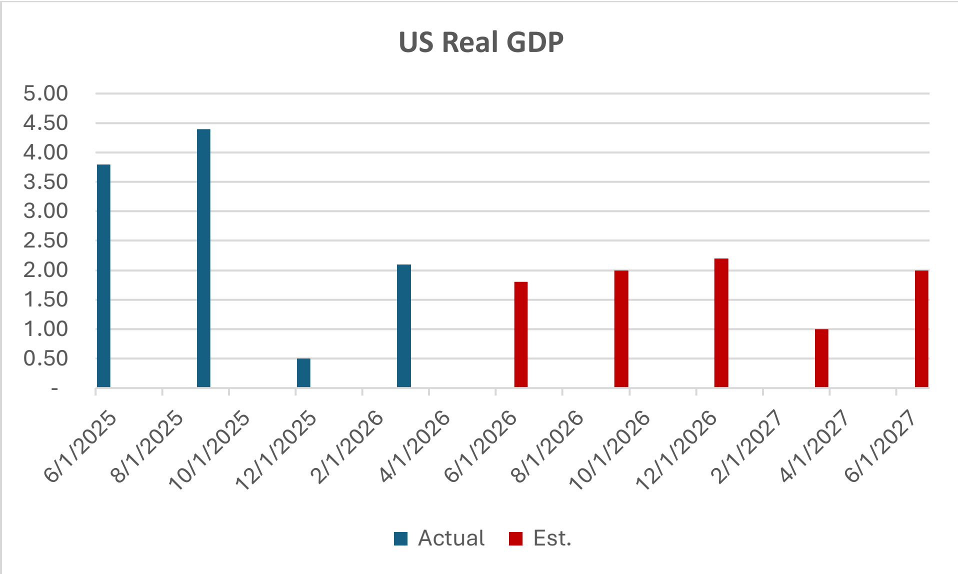


In addition to interest rate decisions, it appears Chair Warsh is prepared to make significant changes to how the central bank operates, including less communication (forward guidance) and shrinking the size of the Fed's balance sheet and limit its use as a determinant for market interest rates.

Despite these developments, the U.S. economy continued to expand in the first half of the year.

Solid consumption trends and meaningful AI-related investment helped support economic demand. Surging energy prices from the war in Iran pressured inflation data, and price measures remained above the Federal Reserve's target. Job growth moderated and wage pressures eased, as aging demographics and tighter immigration policy keep the unemployment rate from rising materially.

Chart – GDP Forecasts



We look for the US economy to grow in the range of 2.0% to 2.5% for the full year, as inflation pressures remain dependent on geopolitics. A moderating, though stable employment market should help support economic activity.

Bottom Line: Despite early-year volatility, the U.S. economy remains supported by consumption, fiscal incentives, and AI-related investment. Policy uncertainty and geopolitical tensions will continue to influence market conditions, but underlying economic momentum remains intact.

Fixed Income

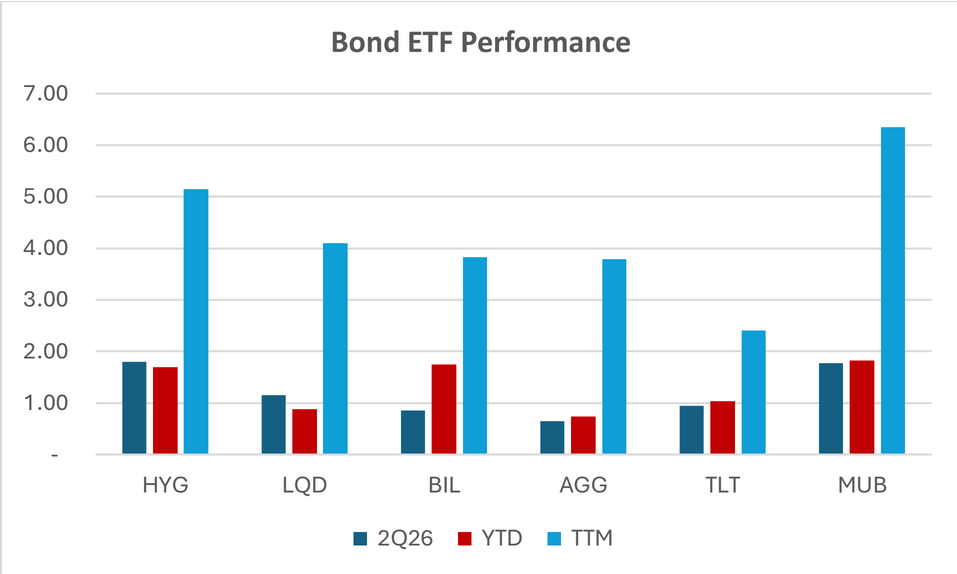
In the first half of 2026, the bond market had to contend with the war in Iran, rising inflation, resilient growth, and a leadership change at the Federal Reserve.

In addition, market interest rates climbed as investors revised expectations for an easing of monetary policy. The yield on the 10-year U.S. Treasury note moved from below 4.0% in early March toward 4.50% by late June, with upside risks remaining.

Higher debt and wider deficits have raised the fiscal concerns of global investors, increasing the compensation demanded for holding longer-term U.S. Treasuries. Kevin Warsh's transition to Fed Chair also added uncertainty amid above-target inflation and tighter global policy.

For fixed income investors, income supported returns, but higher rates weighed on bond prices.

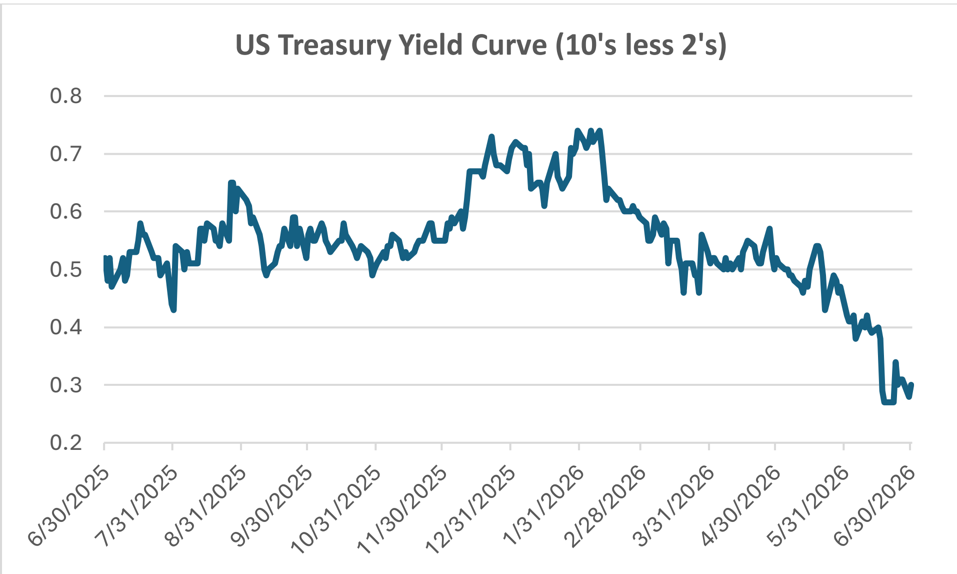
Chart – Bond ETF Performance



While the 10-year Treasury yield rose about 50 basis points in recent months, the 2-year yield has recently traded above the federal funds rate, signaling expectations for higher rates before Chair Warsh fully assesses inflation and employment risks. Indeed, the bond market likes to test new Fed Chairs!

As a result, the U.S. Treasury yield curve has flattened, suggesting the bond market's belief that higher rates could slow future growth.

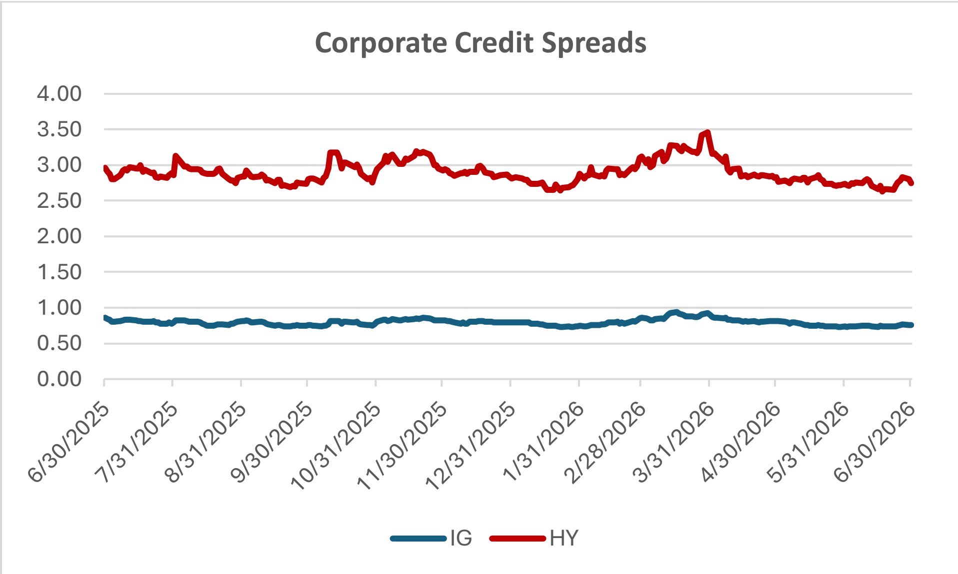
Chart – Yield Curve



Fortunately, corporate credit has held up well despite the surge in AI-driven debt issuance, which is up ~+25% from last year. Intermediate and longer-duration investment grade yields near 5.0% have helped attract demand and absorb the new supply.

We are further encouraged that corporate bond spreads relative to Treasuries remain narrow, suggesting confidence in the economy's ability to withstand potential challenges and limit default risk.

Chart – Corporate Credit Spreads



Municipals securities have also been resilient, with YTD fund inflows above $40 billion and solid state and local credit supported by stronger balance sheets and healthy reserves.

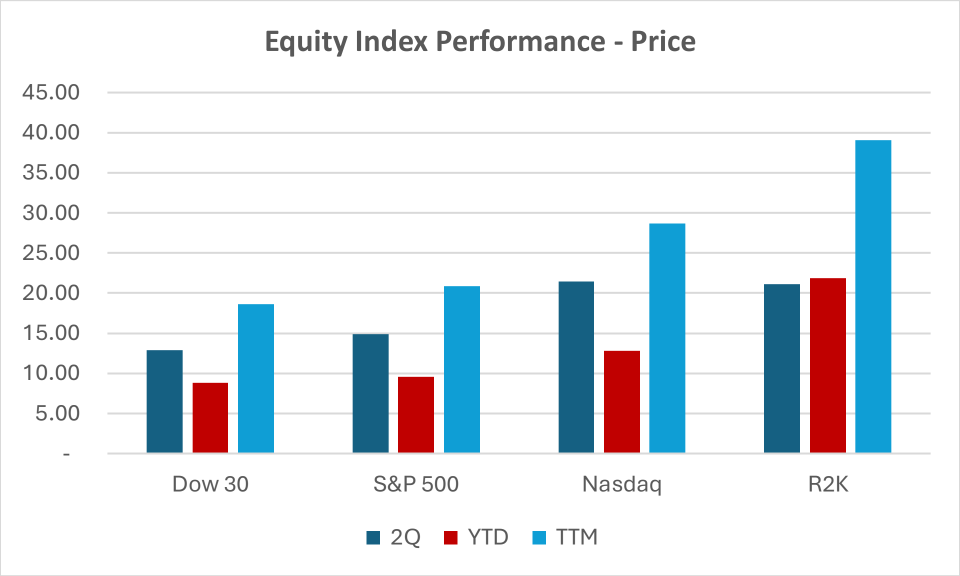
Bottom Line: Fixed income markets still face inflation, fiscal concerns, and policy uncertainty. Yet elevated yields provide income, and strong fundamentals should support demand across government, corporate, and municipal markets.

Equities

The equity markets endured a volatile first half of 2026.

The war in Iran and surging oil prices contributed to a first-quarter drawdown, which was magnified by the altered outlook for monetary policy. This volatility followed by a swift recovery led by AI-related investments, strong corporate profits, and resilient economic demand.

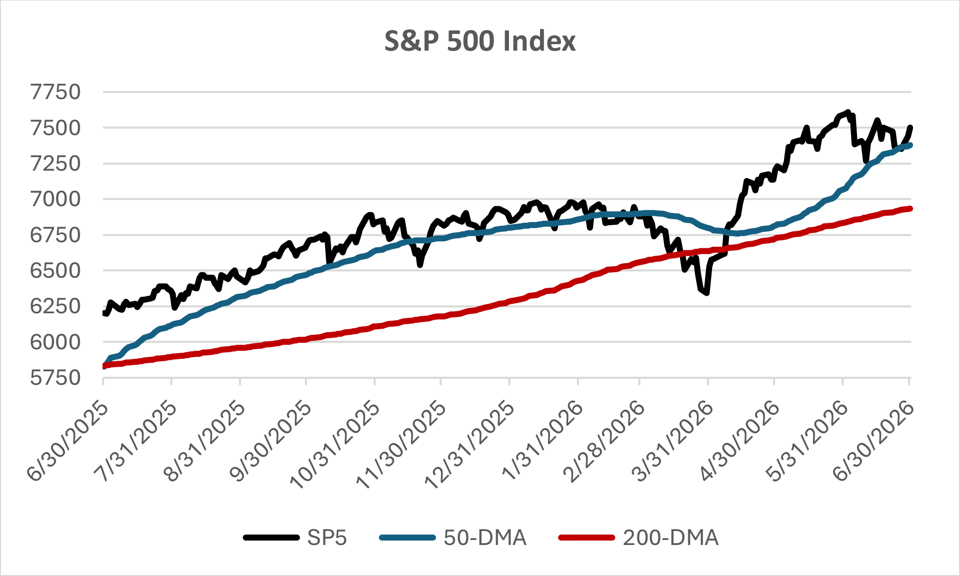
Chart – Major Equity Market Index Performance



Market Technicals

After the late-March swoon, the equity market, as measured by the S&P 500, experienced a strong rally driven by surging profits and AI-related investment.

Chart – S&P 500 Index



Indeed, the Index a favorable condition relative to both momentum and trend, as approximately two-thirds of the companies in the S&P 500 were trading above their 50- and 200-day moving averages (DMA).

Participation also improved as the 1st half of the year progressed with the S&P 500 Equal-Weighted Index finishing the second quarter at a new closing high. Indeed, the rally broadened from technology and AI-related companies to include value and small caps, too.

<u>Market Fundamentals</u>

While technical market patterns based on volume and price can change momentum relatively quickly, the fundamentals of equity valuation and corporate profit growth tend to affirm longer-term trends.

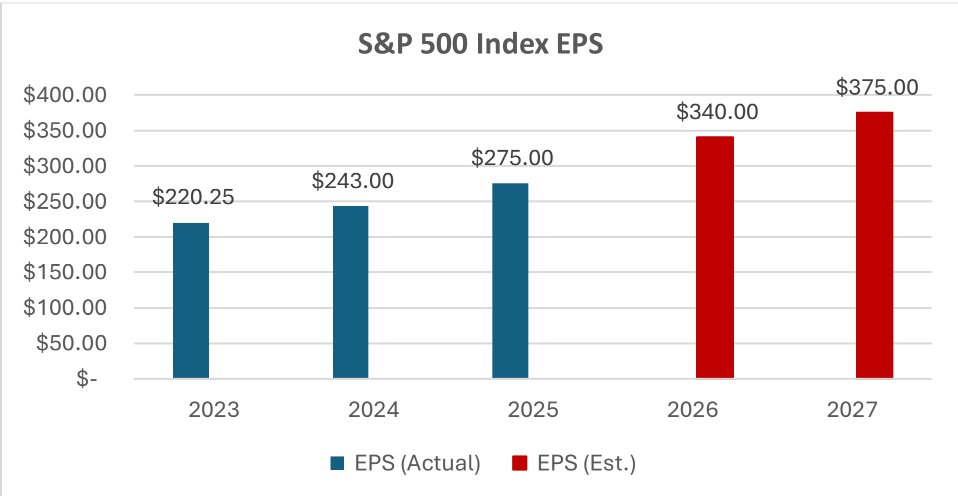
Fortunately, we view the fundamental data as leaning favorably for the equity markets in the months and quarters ahead.

The S&P 500 Index (~7,500) currently trades at ~22 times the FactSet consensus profit forecast of ~$340.00 profits for 2026.

While this price-to-earnings ratio (P/E) is above its longer-term average, we believe that P/E multiples should not be viewed on an absolute basis, but relative to interest rates and inflation, which remain below their multi-decade norms.

A further look into corporate profitability suggests the potential for further equity market upside. After companies in the S&P 500 Index delivered solid earnings gains (~+28.0% YOY) for the first quarter, the FactSet consensus projects earnings per share (EPS) growth of ~+25.0% for each of the remaining three quarters of 2026.

Chart – S&P 500 Index Profits

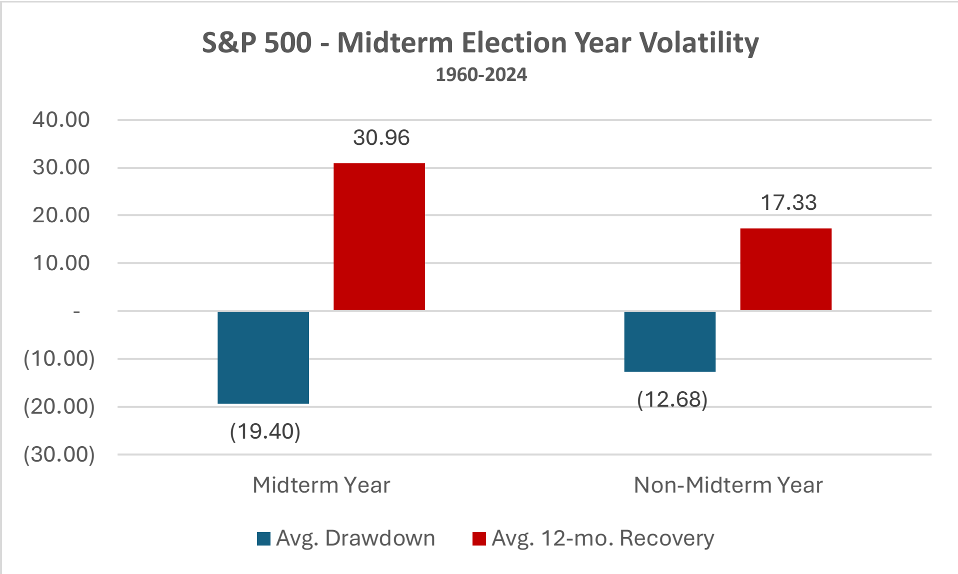


Companies in the Index are also projected to generate additional earnings per share (EPS) growth of ~+18.0% in 2027, to almost $400.00, according to FactSet. While we hope to see this consensus-earnings estimate achieved for the S&P 500, we suspect profit growth may not be quite as robust, and consequently project EPS growth of 10.0% in 2027, to $375.00 for the Index next year.

Applying a forward P/E multiple of 21X our preliminary 2027 S&P 500 EPS estimate of $375.00 gives us a fair value estimate of 7,850 for the Index by yearend. This suggests upside potential of ~+5.0% for the remainder of 2026.

Of course, these gains will likely have to overcome a fair amount of volatility, as the equity market typically endures a pullback of ~-20.0% during mid-term election years.

Chart – Midterm Election Year Volatility



Yet it is important to note that 12 months following the S&P 500's low point in mid-term years, the Index has rebounded by an average of >+30.0%, emphasizing the importance of adhering to one's long-term allocations during periods of market distress.

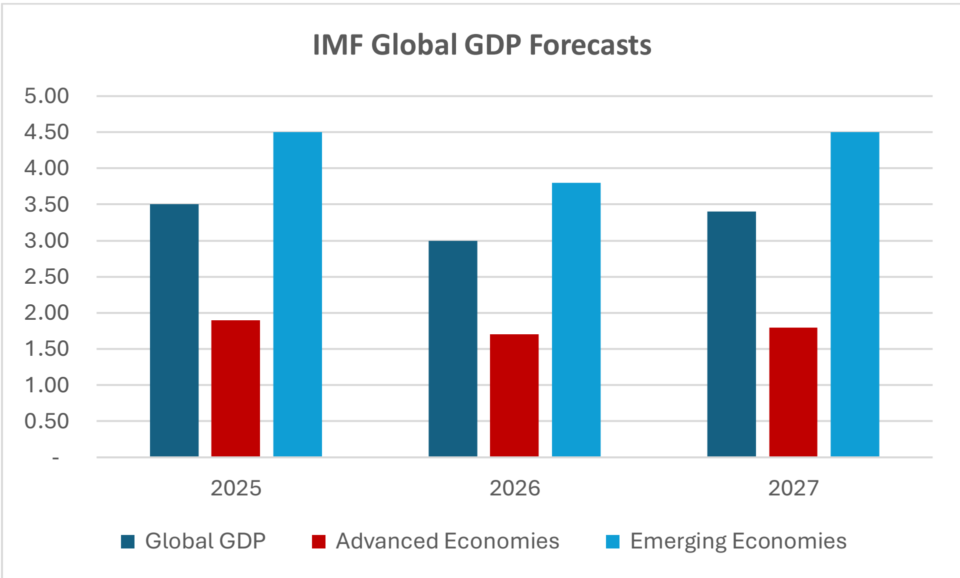
Bottom Line: We believe investors can remain constructive but need to be vigilant in the months and quarters ahead. The tension between near-term earnings momentum and the longer-term sustainability of AI-driven profitability has come into sharper focus. With elevated earnings expectations largely priced in, the path for continued market gains is likely to narrow. While equity markets remain supported by strong earnings and AI-related investment, a combination of higher inflation, geopolitical uncertainty, and midterm election dynamics may contribute to more frequent bouts of volatility in the second half of the year.

Global

The war in Iran and surging energy prices have dramatically altered the outlook for Developed and Emerging economies.

Consequently, the International Monetary Fund (IMF) recently lowered its projections for the global economy in 2026. It now forecasts global GDP growth of 3.0% this year, down from the 3.5% pace in 2025, reflecting the prolonged nature of the conflict and ongoing uncertainty.

Chart – Global GDP

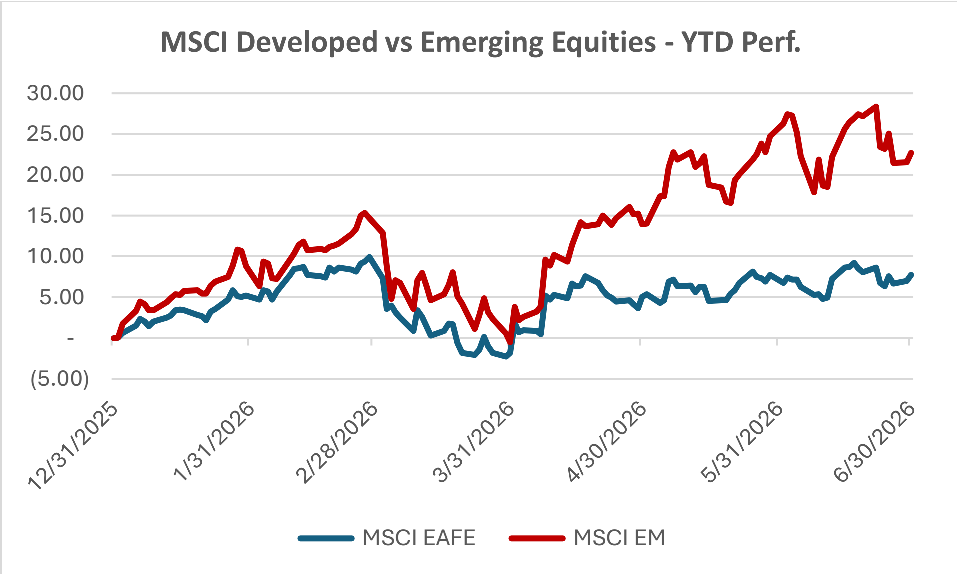


Moreover, global inflation growth was also revised higher, to 4.7% in 2026, up sharply from 4.1% last year, due to disrupted supply chains affecting commodity, agricultural and energy prices.

Despite the gloomier outlook from the IMF, the global economy has shown a fair amount of resilience, resilience, supported by strong investment in artificial intelligence technologies and the adoption of alternative energy sources.

To be sure, the global financial markets have also displayed resilience in the face of geopolitical escalations, currency volatility, tighter monetary policies, and worrying government debt levels.

Chart – Developed vs. Emerging Markets



Despite the global challenges, it is interesting to note the dramatic outperformance of Emerging equity markets relative to Developed nations. These gains can be attributed to a number of factors, including Taiwan and South Korea's exposure to the AI-related boom in semiconductor stocks, China's export growth, and global trade policy realignments, which benefitted many EM countries.

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